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IN THE

# Supreme Court of the United States

**OCTOBER TERM, 1966**

No. 343

PRIMA PAINT CORPORATION,
*Petitioner,*

*v.*

FLOOD & CONKLIN MFG. CO.,
*Respondent.*

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

## BRIEF FOR RESPONDENT

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ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

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## BRIEF FOR RESPONDENT

Respondent adopts petitioner's statement of "Opinions Below" and "Jurisdiction."

### Questions Presented

1. Whether the United States Arbitration Act requires that the interpretation and effect of an arbitration agreement contained in a contract involving interstate commerce be decided under federal law rather than state law.

2. Whether, under federal law, an agreement to arbitrate "any controversy or claim arising out of or relating to this agreement, or the breach thereof" requires an arbitrator rather than a court to hear and determine the issue of fraud in the inception of the contract when the

charge of fraud is not directed to the arbitration agreement which is contained in the contract.

3. Whether a party seeking to stay an arbitration proceeding on the ground that the contract containing the arbitration agreement was induced by fraud must, in any event, show the court upon the application for a stay that there is substance to the allegation of fraud.

## Statement

On October 7, 1964, the parties entered into a written agreement (R. 21) (the "Agreement"), whereunder respondent, Flood & Conklin Mfg. Co. ("F & C"), turned over to petitioner, Prima Paint Corporation ("Prima"), two lists (referred to at paragraph 4(a) of the Agreement as Exhibits "A" and "B", R. 22) bearing the names of F & C's customers for paint and related products. F & C covenanted that it would no longer make any sales of paint or paint products to any of such customers or to anyone else within the territory in which it had made sales during the past year (Para. 3, R. 22). In addition, F & C agreed to render (through Mr. Jerome K. Jelin, its Chairman, except in the event of his death or disability) such advisory and consultative services as Prima might reasonably require in connection with its formulae and manufacturing operations, as well as in respect of sales and servicing of Prima accounts (Para. 2, R. 22).

In return for the immediate disclosure by F & C of its customer lists, for its covenant not to compete, and for its agreement to render advisory and consultative services, as aforesaid, F & C was to be paid a stated percentage of Prima's receipts, over the next six years, from prior customers of F & C and from customers for F & C's products, as defined in the Agreement (Para. 4, R. 22).

The first payment to be made to F & C by Prima was not due until September 1, 1965, the first day of the eleventh month after the effective date of the Agreement (Para. 4(c), R. 23). While the Agreement provides that Prima's total obligation to F & C is not to exceed $225,000 over the six year period (Para. 4(g), R. 24), no minimum amount is guaranteed to F & C; its compensation is entirely dependent on the volume of future sales made by Prima to prior customers of F & C.

Although Paragraph 7 of the Agreement (R. 25) deals at length with the consequences of Prima's becoming bankrupt or otherwise becoming unable to make required payments during the six year term, the Agreement contains no provision relating either to the solvency or to any subsequent insolvency of F & C.

One week after the Agreement was entered into, F & C filed a voluntary petition in the United States District Court for the District of New Jersey under the provisions of Chapter XI of the Bankruptcy Act. As is evident from an affidavit submitted in the instant action by Prima's president, Prima was aware of this filing and of the subsequent progress of the Chapter XI proceeding. He there states the claimed effect such proceedings had upon Prima and upon the benefits Prima had sought to derive from the Agreement (R. 39, 40-41). He terms the result "chaos and havoc (R. 41)."

Notwithstanding the foregoing, Prima in fact made no complaint to F & C or to any of its representatives during the pendency of the Chapter XI proceeding. Rather, Prima continued to exploit the customer lists and the other assets which it had acquired from F & C and to avail itself of such advisory and consultative services as it desired without a hint of any grievance. Thereafter, on March 16,

1965, only five months after the Chapter XI proceeding had been instituted, F & C's Amended Plan of Arrangement with its creditors was confirmed by the Referee in Bankruptcy (R. 34); the Chapter XI proceeding thereby ended and F & C was revested with its assets.

During the ensuing six months Prima continued, without complaint, its use of F & C's consulting services and customer lists. Only on September 17, 1965, when the initial payment to F & C was seventeen days past due, did Prima complain. In a letter to F & C's attorneys, it set forth a series of ten claimed "breaches" on the part of F & C (R. 28), asserting that "Flood & Conklin Mfg. Co. is presently indebted to Prima Paint Corporation for failure to comply with the various provisions of the above described Consulting Agreement * * *" (R. 28), and it deposited the payment then due in escrow in accordance with the provisions of Paragraph 7(v) of the Agreement.

On October 25, 1965, it having by then become apparent that the controversy created by Prima's letter of September 17, 1965 could not be amicably resolved, F & C served Prima with a Demand for Arbitration (R. 31) under the rules of the American Arbitration Association. The commencement of arbitration proceedings was in accordance with the agreement of the parties that

> "Any controversy or claim arising out of or relating to this Agreement, or the breach thereof, shall be settled by arbitration in the City of New York, in accordance with the rules then obtaining of the American Arbitration Association, by three arbitrators, one of whom shall be an attorney-at-law and one of whom shall be a certified public accountant, and judgment upon the award rendered may be entered in any Court having jurisdiction thereof. The costs of arbitration shall be shared equally by Prima and F & C (Para. 8, R. 26)."

By stipulation dated November 2, 1965, F & C extended Prima's time to answer the Demand for Arbitration until November 15, 1965 (R. 33).*

Thereafter, on November 12, 1965, Prima instituted an action against F & C in the United States District Court for the Southern District of New York (R. 18). The complaint alleged jurisdiction on the basis of diversity of citizenship (Prima being alleged to be a Maryland corporation having its place of business in Maryland, and F & C a New Jersey corporation having its principal place of business outside of Maryland), and that the matter in controversy exceeded ten thousand dollars.

Although Prima had claimed ten separate "breaches" in its letter of September 17, 1965 (R. 28), its complaint neither seeks nor alleges any damages, but asks only for a judgment that the Agreement be rescinded (R. 20). The sole ground upon which Prima relies in seeking rescission is that F & C had "fraudulently induced" Prima "to accelerate the execution and closing date of the said agreement herein, from October 21, 1964 to October 7, 1964 (Complaint, para. SIXTH, R. 19)." The fraud charged revolves about the allegation that F & C "represented and stated to Prima that F & C was in all respects a solvent corporation and able to perform all of the terms and conditions of the said agreement on its part to be performed (Complaint, para. SEVENTH, R. 19)." Prima then alleges that it would not have entered into the Agreement but for the "false and fraudulent" statements made by F & C (Complaint, para. TWELFTH, R. 20). The complaint does not allege, however, nor does the Record anywhere indicate,

* Under Section 7 of the Commercial Arbitration Rules of the American Arbitration Association, Prima's time to answer would have otherwise expired seven days after service of the Demand, in which event, if no answer were filed, the claim would have been deemed denied.

that F & C's Chapter XI proceeding in any way prevented F & C from performing any of its undertakings or prevented Prima from obtaining the benefits of its bargain.

No charge is made by Prima that the agreement of the parties to arbitrate disputes, referred to above, was fraudulently induced.

Contemporaneously with the institution of its action, Prima sought a preliminary injunction restraining F & C "from proceeding with arbitration until the question of the validity of the contract, which is the subject matter of the District Court proceedings, can be litigated (R. 12)." Presumably, Prima intends that the controversy concerning the nine other "breaches" claimed in its letter of September 17, 1965 will be resolved by arbitration only if and when Prima loses the trial and subsequent appeal in the action it commenced for rescission.

In none of the papers submitted to the Court by Prima did it attempt to explain how F & C's financial condition was in any way material to the realization by Prima of the benefits contemplated by the Agreement. Prima's reliance, perforce, was on the customer lists, on the agreement of F & C not to compete, and on the availability of Jerome K. Jelin to render consulting services. No charge of fraud is alleged as to any of these matters. Indeed, as asserted in an affidavit submitted in F & C's behalf (R. 17), F & C was asked to and did actually perform its consulting function, and no claim of "fraud" was raised by Prima until a year after the supposed fraud was perpetrated. Prima concedes, in its president's affidavit, that it did not charge F & C with misrepresentation at any time before September 17, 1965 (R. 40).

Nowhere does Prima even attempt to explain why it waited thirteen months after knowledge of F & C's Chapter

XI proceedings before initiating an action seeking rescission on the alleged ground of fraud in the inducement.

Nowhere does Prima explain why it continued to use F & C's customer lists and to avail itself of the consulting services of Mr. Jelin after it became aware of the alleged misrepresentation.

Nowhere does Prima even attempt to discuss how the claimed misrepresentation could have deprived it of the benefit of its bargain in the face of the fact that Prima's sole contractual obligation to F & C is to pay F & C a percentage of future receipts obtained by Prima from F & C's past customers. Prima was obviously not prejudiced, for if it made no sales, it owed F & C nothing.*

In opposition to Prima's motion for an order restraining arbitration F & C cross-moved for an order compelling arbitration and staying the action commenced by Prima (R. 13).

The District Court (Croake, J.), disposing of both motions together, denied Prima's motion to stay arbitration and granted F. & C's motion staying the action pending arbitration (R. 8). In so doing, the court expressly relied upon the precedent established by *Robert Lawrence Company* v. *Devonshire Fabrics, Inc.*, 271 F. 2d 402 (2nd Cir. 1959), *cert. granted* 362 U. S. 909 (1960), *dismissed pursuant to Rule 60*, 364 U. S. 801 (1960).

Prima then appealed to the United States Court of Appeals for the Second Circuit. On F & C's motion (R. 1), that court dismissed the appeal as frivolous, having first reviewed the Agreement and concluded that "Beyond peradventure [it] evidences a transaction involving interstate

* Since Prima has alleged in its complaint that the amount in dispute exceeds ten thousand dollars, it is clear that Prima is in fact making substantial sales to F & C's customers.

commerce (R. 47)." In applying federal law and dismissing the appeal, the court below declined to express any opinion as to the merits of Prima's claim of fraud, for it did not wish to be regarded as "suggesting to the arbitrators the result they should reach (R. 46)." The court below thus reaffirmed its earlier holding in *Robert Lawrence Company* v. *Devonshire Fabrics, Inc.* and concluded by stating that "arbitration should now proceed promptly (R. 50)."

The arbitration proceeding, however, has been held in further abeyance pending the decision of this Court. In the interim, in order to avert acceleration pursuant to clause (v) of paragraph 7 of the Agreement (R. 26), Prima has continued to make payments into escrow of moneys that would otherwise be due to F & C (R. 43). F & C is, however, no nearer to resolution of the controversy created by Prima or to receipt of the funds than it was in October, 1965 when it commenced arbitration proceedings. Thus, by the mere allegation of fraud in the inducement, Prima has already succeeded in frustrating the quick and economical resolution of disputes for which the parties bargained in their arbitration agreement.

## Summary of Argument

### I

In *Bernhardt* v. *Polygraphic Co.*, 350 U. S. 198 (1956) this Court held that the differences between arbitration and judicial determination of a controversy touched upon substantive rights and that accordingly, a federal court sitting in a diversity case must apply local law rather than the United States Arbitration Act when the arbitration provision before it was contained in a contract not within the scope of Section 2 of the Act. *Bernhardt* did not decide whether Section 2 of the Act created a federal right to arbitration so that diversity cases within its scope could be decided without reference to local law.

The court below, in answering this question affirmatively, followed the precedent established by *Robert Lawrence Company* v. *Devonshire Fabrics, Inc.*, 271 F. 2d 402 (2nd Cir. 1959), *cert. granted* 362 U. S. 909 (1960), *dismissed pursuant to Rule 60*, 364 U. S. 801 (1960). The decision that the United States Arbitration Act was meant to create a new body of substantive law is predicated upon the Congressional exercise of its commerce and admiralty powers in Section 2 of the Act. Had the Act been intended to do no more than promulgate a federal procedure for state-created rights, there would have been no need for Congress to limit the Act, as it did, to arbitration provisions in maritime transactions and in contracts involving interstate or foreign commerce.

In enacting the United States Arbitration Act (9 U.S.C. §§ 1-14) in the year 1925, Congress apparently did not expressly consider its application to actions in state courts; however, the Act was generally assumed to include

all matters before the federal courts including those based upon diversity of citizenship. See Cohen & Dayton, *The New Federal Arbitration Law,* 12 Va. L. Rev. 265, 267 (1926); Note, 69 Yale L. J. 847, 852-856 (1960).

*Robert Lawrence* accordingly held that the United States Arbitration Act created national law, applicable in state courts as well as federal courts. In so holding, the court made the choice least likely to frustrate the clear intent of a Congress which was obviously not aware of the doctrine to be enunciated thirteen years later in *Erie R. Co.* v. *Tompkins,* 304 U. S. 64 (1938). The consequences of imposing an obligation upon state courts to apply the United States Arbitration Act in cases dealing with arbitration provisions contained in contracts involving interstate or foreign commerce hardly constitutes an encroachment on important state policies of a magnitude sufficient to outweigh the frustration of Congressional intent which would otherwise ensue by deleting all diversity cases from the operation of the Act even though they come within the scope of Section 2.

The notion that the United States Arbitration Act has created federal substantive law has met with resounding favor among the federal judiciary throughout the Nation and should receive the approval of this Court.

## II

The interpretation and effect of an arbitration provision within the scope of the United States Arbitration Act should be determined under federal law to be fashioned by the courts in accordance with the policy of the Act. If federal law were to adopt local law in such matters, the result would be frustration of Congressional intent even greater than would flow from a decision that

the Act has no application to diversity cases within the scope of Section 2 of the Act. As seen in *Bernhardt* (where the law of Vermont was involved), there are still states which refuse to enforce agreements to arbitrate future disputes. Thus, reference to state law could result in an emasculation of the Act.

## III

There is no public policy which would prevent an agreement to arbitrate all future disputes including a dispute that there had been fraud in the inception of the contract within which the arbitration provision is contained. By applying this approach, the court below properly limited its inquiry to two matters: did the charge of fraud relate to the agreement to arbitrate disputes, and if not, is the particular arbitration provision broad enough to cover the charge of fraud?

The operative language of the arbitration agreement contained in the principal contract is that recommended by the American Arbitration Association. The United States Courts of Appeals for both the First Circuit and the Fifth Circuit, as well as the court below, have held that language to be of such breadth as to compel a finding that the parties intended to arbitrate disputes involving charges of fraud. *Lummus Company* v. *Commonwealth Oil Refining Co.*, 280 F. 2d 915, 931 (1st Cir. 1960), *cert. denied* 364 U. S. 911 (1960); *Electronic & Missle Facilities, Inc.* v. *United States*, 306 F. 2d 554, 555 n.2 (5th Cir. 1962), reversed on other grounds, 374 U. S. 167 (1963). Similar clauses have likewise been held by various state courts to encompass disputes involving fraud.

The fact that Prima's choice of remedy for the alleged fraud is rescission rather than damages should not affect

the arbitrability of the dispute. If the choice of remedy were controlling, a party could have the unilateral, unfettered power, seriously to delay, if not altogether thwart, an arbitration proceeding despite the mandate of Congress that agreements to arbitrate are "valid, irrevocable, and enforceable" (9 U.S.C. §2). As noted in *Lummus Company* v. *Commonwealth Oil Refining Co., supra*, "[A] strong case can be made for construing arbitration agreements as separable from the principal agreements, and as voidable only for fraud directly affecting their existence, as distinguished from representations relating to the content or making of the principal agreements." (280 F. 2d at 924)

Once it has been determined that the arbitration provision is not directly challenged and that it is broad enough to encompass the dispute, the dispute should be referred to the arbitrator.

In any event, rescission is not available in this case because Prima cannot make restitution in any form other than money payments. Accordingly, if arbitration were stayed, all that could possibly be rescinded is the arbitration provision itself, the very part of the Agreement as to which no fraud is alleged.

## IV

In order to obtain a stay of a pending arbitration proceeding, the party seeking the stay in all events should be required to come forward with a demonstration sufficient to indicate that there is substance to the allegations upon which the stay is sought. This Prima has failed to do. Even if it were otherwise able to effect a rescission of the Agreement, its delay in asserting its claim has resulted in a waiver of such right. Nor has Prima shown either reliance upon the alleged misrepresentation or how

any damages could possibly have resulted therefrom. The charge of fraud is sham.

In similar circumstances, the New York Court of Appeals in *Cheney Bros.* v. *Joroco Dresses, Inc.*, 245 N. Y. 375, 157 N.E. 272 (1926) refused to stay an arbitration proceeding without indicating how it would have ruled if the charge of fraud had been substantiated. This Court should affirm the order directing arbitration whether or not it agrees with the court below as to the other issues presented by the instant case.

## I

## The United States Arbitration Act is applicable in determining whether the agreement of the parties to arbitrate disputes should be enforced.

### A. The Agreement Evidences a Transaction Involving Interstate Commerce.

Prima has challenged, as a threshold question, whether the Agreement involves interstate commerce. We agree that if it does not, under the ruling in *Bernhardt* v. *Polygraphic Co.*, 350 U. S. 198 (1956), the application of the United States Arbitration Act (9 U.S.C. §§1-14) would have been erroneous.* However, the finding of the Second Circuit Court of Appeals that "[b]eyond peradventure the contract evidences a transaction involving interstate commerce" (R. 47) is, we submit, clearly correct.

As noted by the court below (R. 47-48), F & C turned over to Prima two lists of F & C's paint customers, which included some 175 establishments located in several states.

* Even in such event, for the reasons stated in Point IV, the order of the court below refusing to stay the arbitration proceeding should be affirmed.

As the court also noted, Prima's president had stated that the Agreement

> "* * * contemplated and intended an orderly transfer of the assets of the defendant [F & C] to the plaintiff [Prima], and further contemplated and intended that the defendant would consult, advise, assist and help the plaintiff so as to insure a smooth transition of manufacturing operations to Maryland from New Jersey, together with the sales and servicing of customer accounts and the retention of the said customers." (R. 48, quoting from R. 40-41)

Accordingly, since Prima concedes (Br. 11) that "evidence how the parties expected the contract to be performed and how it was performed is relevant to whether substantial interstate activity was contemplated," it is apparent that the commerce requirement of Section 2 of the Act has here been satisfied. See concurring opinion of Chief Judge Lumbard in *Metro Industrial Painting Corp.* v. *Terminal Const. Co.*, 287 F. 2d 382, 387 (2nd Cir. 1961), *cert. denied* 368 U. S. 817 (1961).

### B. Congress Has Created a Federal Right to Enforce Arbitration Agreements.

In *Bernhardt* v. *Polygraphic Co.*, 350 U. S. 198 (1956), this Court held that Sections 1 and 2 of the United States Arbitration Act defined the field in which Congress was legislating, and that accordingly, an arbitration provision contained in a contract involving neither a maritime transaction nor commerce, as defined in the Act, was not governed by the Act. The Court then observed that the question before it was thus "whether, apart from the Federal Act, a provision of a contract providing for arbitration is enforceable in a diversity case (350 U. S. at 202)." In holding this to be a question to be resolved in

accordance with state law, the Court noted that arbitration was not a mere form of procedure within the power of the federal courts or Congress to prescribe, but rather, that it touched on substantial rights which, in the absence of an agreement involving commerce, under the doctrine of *Erie R. Co.* v. *Tompkins,* 304 U. S. 64 (1938) were governed by local law.

*Bernhardt* did not decide whether diversity cases involving contracts within the scope of Section 2 of the Act would likewise have to be decided under state law, or alternatively whether Section 2 creates a federal right to arbitration. The first post-*Bernhardt* case to consider this question was *Ross* v. *Twentieth Century-Fox Film Corporation,* 236 F. 2d 632 (9th Cir. 1956), wherein it was held that *Bernhardt* would support the analysis that, even though contained in a contract evidencing a transaction involving interstate commerce, an arbitration provision must be interpreted under state law.

In *Robert Lawrence Company* v. *Devonshire Fabrics, Inc.,* 271 F. 2d 402 (2nd Cir. 1959), *cert. granted* 362 U. S. 909 (1960), *dismissed pursuant to Rule 60,* 364 U. S. 801 (1960), the Court of Appeals for the Second Circuit expressly disagreed with the holding in *Ross* (271 F. 2d at 409 n. 7) and declared that Section 2 of the United States Arbitration Act

> "• • • in making agreements to arbitrate 'valid, irrevocable, and enforceable' created national substantive law clearly constitutional under the maritime and commerce powers of the Congress and that the rights thus created are to be adjudicated by the federal courts whenever such courts have subject matter jurisdiction, including diversity cases, just as the federal courts adjudicate controversies affecting other substantive rights when subject matter jurisdiction over the litigation exists." (271 F. 2d at 409).

The court stated that the intention of Congress to create a new body of federal substantive law affecting the validity and interpretation of arbitration agreements is reasonably clear (*Id.* at 406) and that such national law would be equally applicable in state courts (*Id.* at 407).*

In *American Airlines, Inc.* v. *Louisville & Jefferson C.A.B.*, 269 F. 2d 811 (6th Cir. 1959), a case decided only a few weeks prior to *Robert Lawrence* (and inaccurately characterized by Prima (Br. 13) as "in direct conflict" with *Robert Lawrence*), the Court of Appeals for the Sixth Circuit also held that the Act created national law.

> "The Federal arbitration statute, [9 U.S.C. §§1-14, 61 Stat. 669 (1947)], was enacted in exercise of the Congress' plenary power over interstate commerce. * * * Within the scope of the statute circumscribed by the Constitution, Federal law is of course paramount under the Supremacy Clause, and State law must give way." (269 F. 2d at 815).

The doctrine that the United States Arbitration Act has created national substantive law has met with resounding favor among the federal judiciary. See: *Monte* v. *Southern Delaware County Authority*, 321 F. 2d 870, 873-874 (3rd Cir. 1963); *Electronic & Missile Facilities, Inc.* v. *United States*, 306 F. 2d 554, 558 (5th Cir. 1962), reversed on other grounds, 374 U. S. 167 (1963); *Standard Magnesium*

* The instant case continues the application of this doctrine by the Court of Appeals for the Second Circuit. Since *Robert Lawrence*, it has reaffirmed its position in *Amicisia Societa Nav.* v. *Chilean Nitrate & Iodine S. Corp.*, 274 F. 2d 805 (2nd Cir. 1960), *cert. denied* 363 U. S. 843 (1960); *Metro Industrial Painting Corp.* v. *Terminal Const. Co.*, 287 F. 2d 382 (2nd Cir. 1961), *cert. denied* 368 U. S. 817 (1961); *In re Kinoshita & Co.*, 287 F. 2d 951 (2nd Cir. 1961); *El Hoss Engineer. & Transport Co.* v. *American Ind. Oil Co.*, 289 F. 2d 346 (2nd Cir. 1961), *cert. denied* 368 U. S. 837 (1961); *World Brilliance Corp.* v. *Bethlehem Steel Co.*, 342 F. 2d 362 (2nd Cir. 1965); *Marcy Lee Manufacturing Co.* v. *Cortley Fabrics Co.*, 354 F. 2d 42 (2nd Cir. 1965).

*Corporation* v. *Fuchs*, 251 F. 2d 455, 457-458 (10th Cir. 1957); *Younker Brothers, Inc.* v. *Standard Const. Co.*, 241 F. Supp. 17, 18 (S.D. Iowa 1965); *O'Meara* v. *Texas Gas Transmission Corp.*, 230 F. Supp. 788, 790 (N.D. Ill. 1964); *Southern Bell Tel. & Tel. Co.* v. *Louisiana Power & Light Co.*, 221 F. Supp. 364, 368 (E.D. La. 1963); and *Coastal States Gas Producing Co.* v. *Producing Properties*, 203 F. Supp. 956, 959 (S.D. Tex. 1962).

See also *Agostini Bros. Bldg. Corp.* v. *United States*, 142 F. 2d 854, 855-856 (4th Cir. 1944), a pre-*Bernhardt* case, wherein Judge Parker observed:

> "Congress gave its approval to the principle of arbitration by the enactment of the statute * * * and it manifestly intended to exercise its full power in furtherance of the principle. * * * The Senate Committee * * * rewrote the language in its present form, so as to cover only maritime transactions and transactions involving interstate and foreign commerce. Senate Report No. 536, 68th Cong.; Zip Mfg. Co. *v.* Pep Mfg. Co., D.C., 44 F. 2d 184. This was evidently done because it was realized that Congress had no power to legislate with respect to the validity of contracts generally but only as to the validity of those which related to matters subject to its control."

Prima's contention that the United States Arbitration Act does no more than regulate the manner in which federal courts are to enforce state-created rights (if any) in diversity cases would, if sustained, virtually nullify the Act. According to the position taken by Prima, if under state law an agreement to submit future disputes to arbitration is not binding and can be revoked at any time (as is the apparent case in the State of Vermont, discussed in *Bernhardt*), the Congressional endorsement

of arbitration will to that extent be to no avail in diversity cases.

There is no compelling reason so to limit the effect of the United States Arbitration Act which, by its terms, applies to arbitration provisions in all maritime transactions and contracts involving interstate or foreign commerce. Nor can it be shown that the Act was not intended to apply to diversity cases. On the contrary, that the Congressional intent was to create federal law, applicable in appropriate diversity cases, is supported in the construction given the Act by contemporary lawyers and legislators, among whom it was generally assumed to include diversity litigation. See Cohen & Dayton, *The New Federal Arbitration Law,* 12 Va. L. Rev. 265, 267 (1926); Note, 20 Ill. L. Rev. 111 (1925); Note, 69 Yale L. J. 847, 852-856 (1960).

Prima is, moreover, forced to ignore the fact that Congress specifically limited the scope of the Act to matters in respect of which it unquestionably has constitutional powers. If all that had been intended by Congress was a promulgation of federal procedure to be applied to state-created rights, the Act could have been so drafted as to apply to every case containing an arbitration provision which might for any reason be before a federal court. It is important to note that Congress did not do this. In fact, when in *Bernhardt* this Court construed Section 3 of the Act as limited to areas covered by Section 2, it expressly noted the statement in the Congressional Committee reports that "one foundation of the new regulating measure is 'the Federal control over interstate commerce and over admiralty' (350 U. S. at 202)."

Further, the "procedural" interpretation urged by Prima would render the statutory words "valid" and "irrevocable" in Section 2 mere surplusage.

As noted in *Robert Lawrence,* the Congressional intent to create a new body of substantive law applicable to arbitration agreements affecting commerce or admiralty is reasonably clear. See also the analysis of the Act made by Chief Judge Lumbard in his concurring opinion in *Metro Industrial Painting Corp.* v. *Terminal Const. Co.,* 287 F. 2d 382, 386 (2nd Cir. 1961) *cert. denied* 368 U. S. 817 (1961):

> "The report submitted by the committee of the House of Representatives which drew up the law expressly found authority for its enactment in the power over federal-court procedures granted to Congress by Article III, §1 of the Constitution and the substantive powers of Article I, §8 (interstate commerce) and Article III, §2 (admiralty). Since the Act could not stand after the Supreme Court decision in Bernhardt *v.* Polygraphic Co., supra, as an exercise of the power to control procedures in the federal courts, the alternative basis of legislative authority became the sole ground for invoking the Act in diversity cases. *If it is an exercise of the commerce and admiralty powers, the Act must apply not only to litigation in the federal courts but to suits in state courts as well."* (Emphasis added.)

Admittedly, Congress does not appear to have expressly considered the application of the Act to actions in state courts involving arbitration agreements which are contained in contracts affecting interstate commerce. It is, however, clearly more reasonable to interpret the Act as applicable to all arbitration agreements contained in contracts affecting interstate commerce—whether in state or federal courts—than to emasculate the Act by excising diversity cases from its ambit. Such frustration of the clear intent of Congress that the Act apply to diversity

cases would unjustifiably interfere with a proper exercise of the commerce power without in any way advancing the policy of the *Erie* doctrine. Indeed, the contention that the Act cannot apply to diversity cases because of *Erie* would unnecessarily require this Court to rule on the constitutional issues suggested by Mr. Justice Frankfurter in his concurring opinion in *Bernhardt*. The policy of this Court to avoid ruling on constitutional issues which are not properly before it, and the avoidance of interference with the intent of Congress that the Act apply in diversity cases, requires the approval of the *Robert Lawrence* line of cases, with its necessary corollary that the Act must have equal application to suits in the state courts.

The creation of a federal right to arbitration in contracts involving interstate or foreign commerce may properly be regarded as creating supreme national law on the subject despite the absence of a specific showing of legislative intent to that end. From the fact that Congress limited the scope of the Act to areas within its domain there may reasonably be inferred a legislative intent that the Act be applicable in state courts when the principal contract involves interstate commerce. See Note, 60 Harv. L. Rev. 262 (1946); Note, 69 Yale L. J. 847, 863-867 (1960).

The consequences of imposing an obligation upon state courts to apply the United States Arbitration Act in cases involving arbitration clauses contained in contracts involving interstate commerce hardly constitute an encroachment on important policies (in those states which still disfavor arbitration) of a magnitude sufficient to outweigh the frustration of Congressional intent which would otherwise ensue. On the other hand, the positive advantages contemplated by Congress when, in connection with interstate, foreign and maritime transactions, it provided that uniform

interpretation and effect be given to agreements to submit to arbitration, are substantial: businessmen are thereby assured that the speedy and economical resolution of disputes contemplated by their arbitration agreement will be attained.

Nor do we perceive how a holding that the United States Arbitration Act governs arbitration provisions in contracts involving interstate commerce, whether such contracts are between citizens of one state or of several states, could possibly raise constitutional questions concerning "denial of equal protection of the law and due process of law" as Prima fears (Br. 18). Since Congress may unquestionably enact national substantive law in areas within its domain, and since such law would likewise bind the state courts, the "forum shopping" which so concerns Prima would be to no avail.

Accordingly, this Court should hold that the United States Arbitration Act has created national substantive law, applicable in both federal and state courts, which governs all arbitration provisions which are contained in contracts involving interstate commerce.

## II

## The interpretation and effect of an arbitration provision governed by the United States Arbitration Act should be decided under federal law.

Prima has asserted that even if the Arbitration Act has created federal substantive law, such law should nevertheless be that state law governs disputes over the interpretation and effect of the arbitration clause.* However, if

* Prima also contends that disputes over the "making" of the arbitration agreement, such as those arising by virtue of claims of fraud, duress, mistake, and lack of legal capacity, should be resolved by reference to state law. However, since Prima has not attacked the arbitration provision itself as having been induced by fraud (R. 17) the question of what law should apply to a direct attack on the making

federal law were to adopt local law in matters concerning the interpretation and effect of an arbitration provision, the result would be an even greater frustration of Congressional intent than would a decision that the Act has no application to diversity cases. It would, presumably, require the application of local law even where jurisdiction was based on (e.g.) a government contract.

That the federal courts will have to apply federal law, which the courts will fashion from the policy of the Act, seems almost self-evident. See *Textile Workers* v. *Lincoln Mills*, 353 U. S. 448, 456 (1957). The Act was intended to enable and encourage parties to transactions involving interstate commerce to agree, if they so desired, that future disputes between them would be resolved by arbitration. In 1925, when the law was enacted, the common law hostility to arbitration was still rife. See discussion in *Kulukundis Shipping Co.* v. *Amtorg Trading Corp.*, 126 F. 2d 978, 982-985 (2nd Cir. 1942). Accordingly, if Congress intended no more than a federal law which would defer to local law, the Act would have been meaningless. Clearly, then, the Congressional intent was to provide a uniform, national law concerning the interpretation and effect of arbitration clauses in contracts involving interstate commerce.

Further, Prima's argument assumes that all states will enforce arbitration provisions if only the parties will make

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of the arbitration clause is not presented in this case. It may be noted that in *Moseley* v. *Electronic & Missile Facilities*, 374 U. S. 167 (1963) wherein this Court found that the issue of fraud went to the arbitration clause itself, and therefore remanded for a determination of the issue, it did not specify whether federal or state law should govern. In *American Airlines, Inc.* v. *Louisville & Jefferson C.A.B.*, 269 F. 2d 811, 816 (6th Cir. 1959), the court indicated that it would apply state and federal law. *Robert Lawrence*, on the other hand, seems to intimate that it would apply federal law. It is however unlikely that different results would ensue on questions such as fraud, duress, etc., no matter which law applies.

"use of sufficiently explicit language (Br. 22)." However, the old common law hostility to arbitration still appears to prevail in certain states which refuse to enforce agreements to arbitrate future disputes. The law of Vermont, as discussed in *Bernhardt*, is an example.* Accordingly, reference to state law would create a situation substantially different from that postured in *Auto Workers* v. *Hoosier Corp.*, 383 U. S. 696 (1966). Reference to state law for the interpretation and effect of an agreement to arbitrate future disputes would result in the complete nullification of such arbitration clauses in those states which will not, under their local law, enforce such agreements. The Arbitration Act would thus be rendered as impotent as if it had never been enacted at all.

Accordingly, it is submitted that the cases following *Robert Lawrence*, which apply federal law for the interpretation and effect of an arbitration agreement, are correct and that the contrary position of *Ross* v. *Twentieth Century-Fox Film Corporation*, 236 F. 2d 632 (9th Cir. 1956) should be rejected.

## III

**A charge of fraudulent inducement of the principal contract is referable to arbitrators if encompassed by the particular arbitration agreement.**

In *Robert Lawrence*, the Court of Appeals for the Second Circuit set forth four questions to be resolved in order for a court to decide whether or not a charge of fraud in the inception of a contract was arbitrable:

> "(1) is there anything in the Arbitration Act or elsewhere to prevent the parties from making a

* For a discussion of the enforcement afforded arbitration provisions in various states, see Aksen, *Arbitration of Disputes Arising From Architectural, Engineering and Construction Contracts*, Am. Inst. of Architects Journal, February and April, 1964; see also Note, 56 Colum. L. Rev. 902, 903-904 (1956).

> binding agreement to arbitrate any disputes thereafter arising between them, including a dispute that there had been fraud in the inception of the contract; (2) is the exception of Section 2, 'save upon such grounds as exist at law or in equity for the revocation of any contract' applicable if such an agreement to arbitrate has been made and the only fraud charged is fraud in inducing the purchase of goods, rather than fraud in connection with the making of the agreement to arbitrate; (3) did the parties in the case before us make a binding agreement to arbitrate; and (4) is the arbitration clause broad enough to cover the charge of fraud." (271 F. 2d at 409)

Answering the first question, the court found

> "no public policy that would stand as a bar to an agreement of such obvious utility. • • • Indeed, the difference between fraud in the inducement and mere failure of performance by delivery of defective merchandise depends upon little more than legal verbiage and the formulation of legal conclusions." (271 F. 2d at 410)

Other jurisdictions agree that no public policy would prevent the enforcement of such an agreement. *Lummus Company* v. *Commonwealth Oil Refining Co.*, 280 F. 2d 915, 924 (1st Cir. 1960), *cert. denied* 364 U. S. 911 (1960); *Nelley* v. *Baltimore City*, 224 Md. 1, 166 A. 2d 234 (1960); *Amerotron Corp.* v. *Maxwell Shapiro Woolen Co.*, 3 A.D. 2d 899, 162 N.Y.S. 2d 214 (N. Y. App. Div., 1st Dept. 1957) affirmed w/o opinion, 4 N. Y. 2d 722, 148 N.E. 2d 319 (1958); *McElwee-Courbis Construction Co.* v. *Rife*, 133 F. Supp. 790 (M.D. Pa. 1955).

The court, in *Robert Lawrence*, then enunciated its belief that the Arbitration Act envisaged a distinction between the principal contract and the arbitration agreement

therein. Thus, a charge of fraud as to the principal contract would not vitiate the arbitration agreement unless the arbitration agreement was itself fraudulently induced.

By this approach, the court below limited its inquiry to whether the parties had made a binding agreement to arbitrate and whether the arbitration clause they used was broad enough to cover the charge of fraud. Having satisfied itself as to these two matters, the court below dismissed Prima's appeal as frivolous, thereby affirming the order directing arbitration.

### A. The Arbitration Agreement of the Parties Encompasses Disputes Involving Charges of Fraudulent Inducement.

Prima has asserted that "it is a ridiculous conclusion to believe that men consciously and separably would agree to arbitrate any fraud that would give rise to an action to set aside their agreement (Br. 26)." On the contrary, not only is such a conclusion not "ridiculous" but it is entirely consistent with the reasons why businessmen voluntarily agree that they will arbitrate, rather than litigate, their future disputes. Certainly, parties to a business transaction do not expect fraud. Nor do they expect breach of warranty, failure of performance, lack of good faith, or any other dispute to arise. An arbitration agreement is selected as a means for resolving disputes which the parties hope and expect will never arise. In *Wilko* v. *Swan*, 346 U. S. 427, 431-432 (1953), this Court noted the Congressional recognition of arbitration as a desirable alternative to the complications, delay, and expense of litigation. The inclusion of an arbitration agreement in literally thousands of contracts, including the Agreement at issue in this case, demonstrates that businessmen and their attorneys are aware of the same merits of arbitra-

tion which Congress recognized. It may similarly be assumed that they are aware of its shortcomings, some of which are recounted in *Bernhardt*.

However, the fact remains that in the Agreement in this case Prima voluntarily determined that the merits of arbitration outweigh its shortcomings, for it chose of its own accord to enter into a solemn, written agreement that "Any controversy or claim arising out of or relating to this Agreement, or the breach thereof, shall be settled by arbitration * * *" (R. 26). This language is clearly broad enough to compel a finding that the parties intended to arbitrate precisely such a dispute as has now arisen. Such was the opinion of the courts which decided *In re Kinoshita & Co.*, 287 F. 2d 951, 953 (2nd Cir. 1961), *Lummas Company* v. *Commonwealth Oil Refining Co.*, 280 F. 2d 915, 931 (1st Cir. 1960), *cert. denied* 364 U. S. 911 (1960) and *Electronic & Missile Facilities, Inc.* v. *United States*, 306 F. 2d 554, 555 n.2 (5th Cir. 1962), reversed on other grounds, 374 U. S. 167 (1963) in each of which substantially the same language was either discussed or involved.

Similar arbitration agreements have likewise been held to encompass disputes involving fraud. In *Amerotron Corp.* v. *Maxwell Shapiro Woolen Co.*, 4 N. Y. 2d 722, 148 N. E. 2d 319 (1958) the New York Court of Appeals affirmed without opinion the decision below (3 A.D. 2d 899, 162 N.Y.S. 2d 214) that an agreement to arbitrate "any controversy or claim arising under or in relation to" the contract was broad enough to require an arbitrator to determine the question of fraudulent inducement.*

* The clause does not appear in the New York Reports. It may be found in the opinion of the Supreme Judicial Court of Massachusetts in *Maxwell Shapiro Woolen Co.* v. *Amerotron Corp.*, 339 Mass. 252, 254n, 158 N.E. 2d 875 (1959) wherein that court dealt with the Massachusetts court proceedings which had been stayed pending the arbitration in New York.

In *M. W. Kellogg Co.* v. *Monsanto Chemical Co.*, 9 A.D. 2d 744, 745, 192 N.Y.S. 2d 869 (N. Y. App. Div. 1st Dept. 1959), the court affirmed reference to arbitration of a dispute concerning fraudulent inducement where the arbitration agreement encompassed "All claims, disputes, differences and controversies arising under or in connection with the agreement."

In *Fabrex Corporation* v. *Winard Sales Company*, 23 Misc. 2d 26, 200 N.Y.S. 2d 278 (Sup. Ct., N. Y. Co. 1960), the court held that the question of fraudulent inducement was for the arbitrator where the arbitration agreement provided that "Any controversy arising under or in relation to this contract or order or any modification thereof shall be settled by arbitration."

Finally, in *Nelley* v. *Baltimore City*, 224 Md. 1, 166 A. 2d 234 (1960), the court regarded an agreement that "the Director of Public Works will be the referee in case any question shall arise between the Contractor and the City touching the Contract, and his determination, decision and/or estimate shall be final and conclusive upon the Contractor * * *" (224 Md. at 6, 166 A. 2d at 236), as "broad enough to include disputes involving claims of concealment or misrepresentation in the inducement of the substantive contract; * * *" (224 Md. at 14, 166 A. 2d at 240). It is particularly noteworthy that this case was decided some four years prior to the instant Agreement by the highest court of the state in which Prima is incorporated and has its principal place of business.

It is therefore clear that the arbitration agreement entered into by Prima is broad enough to mandate a finding that it was the intention of the parties to include the issue of fraud in the inducement of the principal contract as arbitrable. Prima's efforts to evade arbitration reflect

no more than a one-sided change of mind which is forbidden by Section 2 of the United States Arbitration Act.

### B. The Nature of the Remedy Sought Should Not Affect the Validity, Irrevocability or Enforceability of the Arbitration Agreement.

Prima contends that its choice of remedy (*i.e.*, the fact that its complaint seeks rescission of the Agreement rather than damages) requires a court, and not an arbitrator, to hear and determine the issue of fraud in the inception of the Agreement. In rejecting this contention, the court below held, *as a matter of federal law,* that an arbitration agreement is separable from the contract within which it is contained, and if there is no allegation that the clause itself was fraudulently induced, and if the clause is broad enough to cover a dispute over fraudulent inducement, "the resolution of whether there was in fact fraud in the inducement is properly the province of the arbitrators and not of the court." (R. 49)

Prima has not argued, as indeed it cannot, that an arbitrator who is qualified to decide the issue of fraud in the context of a claim for damages is somehow not as well qualified to pass upon the same issue of fraud if it arises in the context of a claim for rescission. What Prima does argue is that the ruling below has "destroyed the petitioner's inherent right to elect its remedy." (Br. 24)

Of course, Prima is confusing the concept of remedy with the concept of forum. By consenting to an arbitration clause Prima has voluntarily chosen a forum, and has waived its right to a future change of such forum. It has not, however, waived its right to seek rescission of the

Agreement, which the arbitrators are free to grant, nor has the court below in any way intimated to the contrary.*

Prima's argument comes down to the proposition that a party may abrogate an otherwise "valid, irrevocable, and enforceable" (9 U.S.C. §2) agreement to arbitrate disputes simply by instituting an action for rescission of the principal contract without in any way attacking the arbitration agreement itself. A similar argument was rejected in *Robert Lawrence* wherein the court stated:

> "That the Arbitration Act envisages a distinction between the entire contract between the parties on the one hand and the arbitration clause of the contract on the other is plain on the face of the statute. Section 2 does not purport to affect the contract as a whole. On the contrary, it makes 'valid, irrevocable, and enforceable' only a 'written provision in any maritime transaction or a contract evidencing a transaction involving commerce to settle by arbitration a controversy thereafter arising out of such contract or transaction'; and Section 3 provides for the granting of a stay in any suit or proceeding in the federal courts 'upon an issue referable to arbitration under an agreement in writing for such arbitration.'" (271 F.2d at 409-410.)

Section 4 of the Act lends further support to the concept of separability, for it provides for an order directing the parties to proceed with arbitration if the court is "satisfied that the making of the agreement for arbitration or the failure to comply therewith is not in issue." Section 4 goes on to provide that: "If the making of the arbitration

* Section 42 of the Commercial Arbitration Rules of the American Arbitration Association provides in part: "The Arbitrator may grant any remedy or relief which he deems just and equitable and within the scope of the agreement of the parties, including, but not limited to, specific performance of a contract."

agreement or the failure, neglect, or refusal to perform the same be in issue, the court shall proceed summarily to the trial thereof."

Since Prima has nowhere alleged any fraud with respect to the making of the arbitration agreement itself, that agreement should not be disregarded when Prima tries to rescind the principal contract. Indeed, if the charge of fraud were directed to the arbitration agreement, Section 4 of the Arbitration Act would afford a means for summary determination of the question. Certainly, therefore, when the charge does not even involve the agreement to arbitrate, there can be no compelling reason why an arbitration proceeding should have to await the resolution of the question of fraud by a plenary trial.

In *Lummus Company* v. *Commonwealth Oil Refining Co.*, 280 F.2d 915, 924 (1st Cir. 1960) *cert. denied* 364 U. S. 911 (1960), the Court of Appeals for the First Circuit expressed the view that:

> "[A]ny other approach sets the stage for delaying action, and invites the injured party to cast what is basically a claim for breach of warranty or failure to perform, which would be arbitrable, into an action based on fraudulent inducement * * *. [A] strong case can be made for construing arbitration agreements as separable from the principal agreements, and as voidable only for fraud directly affecting their existence, as distinguished from representations relating to the content or making of the principal agreements."

Nor is the doctrine of separability novel, or unique to the federal law suggested in *Robert Lawrence.* In Nussbaum, *The Separability Doctrine in American and Foreign Arbitration,* 17 N.Y.U.L.Q. 609 (1940), the author reviews the European doctrine that the arbitration agree-

ment may have an independent existence and confer on the arbitrators the exclusive power to decide on the validity of the main agreement. He concludes that the trend of European courts is definitely to entrust to the arbitrator the decision on the defenses of fraud and mistake, though decisive of the validity of the main contract.

The concept of separability would seem also to be supported by *Moseley* v. *Electronic & Missile Facilities,* 374 U. S. 167 (1963) wherein this Court reversed a decision of the Court of Appeals for the Fifth Circuit (which had applied the theory of separability) on the ground that "the issue [of fraud] goes to the arbitration clause itself, since it is contended that it was to be used to effect the fraudulent scheme (374 U. S. at 171)." Had this Court desired to reject the theory of separability, it could have expressly done so in *Moseley* and not have had to reach the question whether the arbitration clause was "to be used to effect the fraudulent scheme."

By limiting their inquiry to what the parties intended by the language of their arbitration agreement, other courts have likewise concluded that when rescission was sought on the basis of fraudulent inducement, the issue was for the arbitrators.

Thus, in *Fabrex Corporation* v. *Winard Sales Company,* 23 Misc. 2d 26, 27, 200 N.Y.S. 2d 278, 280 (Sup. Ct. N. Y. Co. 1960), the court held in staying an action that sought rescission:

> "Where an arbitration clause is broad and all inclusive, a request for rescission, either in a pending action or in a demand for arbitration, based upon fraud in the inducement, will be left for determination of the arbitrators (Citations omitted.) * * * In the case before me the arbitration clause is of the broadest scope. Clearly, such a clause may provide for the determination of such questions of fraud and rescission."

The same result was reached in *Matter of Amphenol Corporation,* 49 Misc. 2d 46, 266 N.Y.S. 2d 768 (Sup. Ct. N. Y. Co. 1965), affirmed w/o opinion, 25 A.D.2d 497, 267 N.Y.S. 2d 477 (N. Y. App. Div., 1st Dept. 1966), wherein the party seeking rescission on the ground of fraudulent inducement had instituted arbitration proceedings to determine that issue. The Court denied a motion by the party opposing rescission to stay such arbitration.

Thus, the New York courts require arbitration of the issue of fraudulent inducement even where the relief sought is rescission, and they do so whether the party seeking the rescission is the one requesting or the one resisting the arbitration proceeding. The scope of the arbitration agreement is decisive, as it should be.

Since an arbitrator could unquestionably determine that there had been no meeting of the minds where fraud, or breach of warranty, or mutual mistake is asserted as a defense in an arbitration proceeding, and since it would not be seriously contended that such determination *eo instanti* divested the arbitrator of his power to decide that there was in fact no binding contract, the result should not differ when the same relief is requested affirmatively. In both instances, the arbitrator's power is derived from a then existing contract. To contend that the arbitrator's authority is dependent upon whether the validity of the principal contract is attacked defensively rather than affirmatively is to sacrifice substance to accidents of form.

In *Matter of Grayson-Robinson Stores,* 8 N. Y. 2d 133, 138, 168 N.E. 2d 377 (1960), the New York Court of Appeals observed:

> "Arbitration is by consent and those who agree to arbitrate should be made to keep their solemn, written promises. Such is New York State's public

> policy, plainly written in article 84 of the Civil Practice Act. The courts should follow a 'liberal policy of promoting arbitration both to accord with the original intention of the parties and to ease the current congestion of court calendars.' Lawrence Co. *v.* Devonshire Fabrics, 2 Cir., 271 F.2d 402, 410."

It is submitted that this Court should not tolerate tactics designed solely to frustrate and delay an arbitration proceeding when the relief sought in litigation is just as available in arbitration. Rather, this Court should adopt a policy which will not permit attempts to evade the Congressional mandate that arbitration agreements are "valid, irrevocable, and enforceable."

### C. In Any Event, Prima's Demand for Rescission Is Without Foundation.

Even assuming *arguendo* that Prima had made a *prima facie* showing of fraud, it could not, because of the subject matter of the Agreement, effect a rescission. Thus, its casting of its action in terms of that remedy in order to invoke a claimed distinction between an action seeking rescission and one seeking damages is a cynical and sterile academic exercise.

In the instant case, F & C gave Prima its customer lists, its consulting services, and its covenant of non-competition. Prima was to pay to F & C a percentage of its receipts on the sales it made to the former customers of F & C. Since Prima has made substantial sales to these customers, and would therefore owe money to F & C, it is clear that Prima has already received benefits which it is unable to return in any form other than by payment therefor. Moreover, Prima cannot divest itself of its knowledge of F & C's customers, nor has

Prima offered to stop making sales to such customers. (Interestingly, if Prima ceased making sales to the F & C customers, there would be no need to sue for rescission since Prima's only liability to F & C, except with respect to sales already completed and not capable of rescission, is based on future sales to such customers). Since any substituted form of restitution would perforce take the form of money payments to F & C, the end result would be identical with a successful action for damages whereby Prima would offset its contractual payments by the amount of the damage award it obtained.

The result of permitting a rescission action to forestall an arbitration proceeding would, therefore, be the same as in the analogous situation presented in *Lummus Company* v. *Commonwealth Oil Refining Co.*, wherein the Court stated:

> "It is significant that we have nowhere found a case where a party has succeeded in effecting rescission, and has at the same time retained *in its own possession* all of the very res which constituted the tendered performance of the other side. Even assuming that such a result might be allowed 'if justice cannot otherwise be done,' we do not believe that a desire to avoid arbitration constitutes such an imperative where nothing else in the case suggests that rescission and restitution are necessary to afford Commonwealth compensation for its injury. To allow Commonwealth to rescind and to keep the fruits of the contracts by permitting it to make substituted restoration would be just another way of allowing it to rescind merely the arbitration clauses, the very part as to which there was no fraud." (Emphasis by court). 280 F.2d at 929.

It is accordingly submitted that each and every argument Prima has advanced as to why arbitration should not now proceed is without merit.

## IV

**This Court should affirm the refusal to stay arbitration since Prima has failed to demonstrate substance to its claim of fraud.**

Whether or not the Arbitration Act applies and whether or not the issue of fraud or the remedy of rescission is held by this Court to be determinable by a court, and not by an arbitrator, the order of the court below refusing to stay the pending arbitration proceeding should nevertheless be affirmed because Prima has not come forward with any facts which would give substance either to its charge of fraud or to its request for rescission.

In the various contexts in which the appropriateness of injunctive relief has been raised, the federal courts have consistently required, before injunctive relief will be granted, a showing not only that irreparable injury would otherwise result but that there is reasonable probability of success on the merits. *Continental Oil Company* v. *Frontier Refining Company*, 338 F.2d 780, 781 (10th Cir. 1964); *H. E. Fletcher Co.* v. *Rock of Ages Corporation*, 326 F.2d 13, 17 (2nd Cir. 1963); *Societe Comptoir de L'Indus., etc.* v. *Alexander's Dept. St.*, 299 F.2d 33, 35 (2nd Cir. 1962); *Crane Company* v. *Briggs Manufacturing Company*, 280 F.2d 747, 749 (6th Cir. 1960).

Prima has moved pursuant to Fed. R. Civ. P. 65, to stay a pending arbitration proceeding. It is submitted that the same test should apply here as is applied in granting preliminary injunctions in other contexts. The application of the test of reasonable probability of success to the facts of the instant case will confirm that Prima was not entitled to a stay of the pending arbitration proceedings.

Such was the approach taken by the New York Court of Appeals in *Cheney Bros. v. Joroco Dresses, Inc.*, 245 N. Y. 375, 157 N.E. 272 (1926). The court had before it for review a 3-2 holding of the intermediate appellate court which had stayed an arbitration proceeding on the ground that "whether or not the contract was fraudulently induced raises an issue of fact which must be tried before the right to arbitration under the contract may be enforced (218 App. Div. 652, 219 N.Y.S. 96)." The New York Court of Appeals unanimously reversed without having to reach the ground upon which the court below had based its decision. The Court of Appeals found that no fraud in procuring the contracts had been shown, and accordingly it refused to allow an unsubstantiated claim of fraud to stay an arbitration proceeding. Under these circumstances, the court concluded that "the question whether arbitration could be compelled to determine an issue made as to the procurement of a contract by fraud is, therefore, not before us and will not now be determined." (245 N. Y. at 376-377).

Similarly, in *Lummus Company* v. *Commonwealth Oil Refining Co.*, the Court of Appeals for the First Circuit reversed an order staying arbitration holding, after reviewing the alleged fraud, that:

> "• • • If the agreements to arbitrate are separable from the principal agreements no ground has been shown for their avoidance. If they are not separable, we hold it has shown no basis for rescission at all.
>
> "Since Commonwealth failed to raise a substantial issue as to the making or the existence of the contracts, it was not entitled to a preliminary stay of the arbitration proceedings." (280 F.2d at 930-931.)

In *Robert Lawrence*, a case decided under the doctrine of separability, the Court of Appeals for the Second

Circuit recognized that if the arbitration clause itself were induced by fraud, there could obviously be no arbitration. However, the court indicated that it would grant a stay and order a judicial trial only "if the party charging fraud shows there is substance to his charge." (271 F.2d at 411)

The Record herein indicates that Prima has failed to show the slightest substance to its belated claim for rescission or to its irresponsible cry of fraud. Accordingly, this Court could affirm the order below, refusing to stay the arbitration proceeding, without even reaching the other questions presented by this case.

**A. Prima Has Waived Any Right It May Have Had To Rescind the Contract.**

Prima's unconscionable behavior in remaining silent for eleven full months after F & C's alleged oral misrepresentation of solvency came to light, while continuing to exploit the assets acquired and the consulting services offered, clearly bars it from now obtaining rescission of the Agreement irrespective of the other reasons set forth in Point III above as to why the remedy of rescission is not here available.

As this Court stated in *Grymes* v. *Sanders*, 93 U. S. 55, 62 (1876):

> "Where a party desires to rescind upon the ground of mistake or fraud, he must, upon the discovery of the facts, at once announce his purpose and adhere to it. If he be silent, and continue to treat the property as his own, he will be held to have waived the objection, and will be conclusively bound by the contract, as if the mistake or fraud had not occurred. He is not permitted to play fast and loose. Delay and vacillation are fatal to the right which had before subsisted."

This general rule of law is followed by the State of Maryland where Prima is incorporated and has its principal place of business, by the State of New Jersey where F & C is incorporated and by the State of New York where the arbitration is to take place. See *Wolin* v. *Zenith Homes, Inc.*, 219 Md. 242, 146 A. 2d 197 (1959), *cert. denied* 361 U. S. 831 (1959); *Dover Shopping Center, Inc.* v. *Cushman's Sons, Inc.*, 63 N. J. Super. 384, 164 A. 2d 785 (App. Div. 1960); *Ajamian* v. *Schlanger*, 20 N. J. Super. 246, 89 A. 2d 702 (App. Div. 1952); *New York Tel. Co.* v. *Jamestown Tel. Corporation*, 282 N. Y. 365, 372, 26 N.E. 2d 295 (1940).

Prima's conduct is surely such as to require a court to refuse to grant rescission of the Agreement, especially when the Record does not disclose a single reason to counter the legal conclusion that Prima's delay has resulted in a ratification of the Agreement.

**B. There Is No Substance To Prima's Claim of Fraud.**

Prima's complaint nowhere alleges or suggests that it has been damaged in any way by the alleged misrepresentation of solvency. Prima merely claims that in reliance on F & C's alleged oral representation, it was induced to accelerate the closing date and enter into the Agreement (R. 20). It may be noted that the Agreement contains no representation of solvency and states that the "Agreement embodies the entire understanding of the parties • • •" (R. 27)

Prima cannot demonstrate that it was damaged. The Agreement entered into by the parties requires Prima to pay F & C a stated percentage of Prima's receipts from sales to former F & C customers whose names were disclosed to Prima pursuant to the Agreement. No minimum payments are guaranteed to F & C. Thus, the

extent of Prima's obligation to F & C depends solely upon the volume of sales made by Prima. If Prima makes no sales, F & C is not entitled to any payments. Since Prima's obligation depends only upon the value to it of the assets sold, there is no way it can demonstrate any damages.

To sustain an action based upon fraud, the party claiming to have been defrauded must make a showing of damages.

> "Undoubtedly in an action at law for fraud or deceit, since the action sounds in damage, the plaintiff must prove damage to establish a right to recover." *United States* v. *Dunn*, 268 U. S. 121, 131 (1925).

The same rule applies in those states which have any connection with this transaction.

> "Legal fraud consists of a material representation of a presently existing or past fact, made with knowledge of its falsity, with the intention that the other party rely on it, and he does so rely to his damage. In equitable fraud the second element (knowledge) is not necessary, but the other four are essential." *Dover Shopping Center, Inc.* v. *Cushman's Sons, Inc.*, 63 N. J. Super. 384, 391, 164 A.2d 785, 789 (App. Div. 1960).

The elements of an action based upon fraud under the law of Maryland are the same as those required under the law of New Jersey. See *Lambert* v. *Smith*, 235 Md. 284, 201 A.2d 491, 493 (1964); *Cox* v. *Tayman*, 182 Md. 74, 32 A.2d 368, 370 (1943).

Similarly, the New York Court of Appeals has held:

> "To maintain an action based on fraudulent representations, whether it be for the rescission of a contract or, as here, in tort for damages, it is sufficient to show that the defendant knowingly uttered a falsehood intending to deprive the plain-

> tiff of a benefit and that the plaintiff was thereby deceived and damaged." *Channel Master Corp.* v. *Aluminum Ltd.*, 4 N.Y.2d 403, 406-407, 151 N.E.2d 833 (1958).

Nor is Prima's allegation of reliance on the alleged misrepresentation substantiated by the Record. F & C's assertion that "plaintiff's [Prima's] reliance, as manifested in the negotiations and in the Consulting Agreement, as well as in its conduct subsequent to October 14, 1964, was upon the customer lists of defendant [F & C] which were delivered to plaintiff on October 7, 1964, on the agreement of defendant not to compete, and on the availability of Jerome K. Jelin, an officer of defendant, to render consulting services • • •" (R. 17) remains uncontradicted. Prima submitted an affidavit in which it specifically referred to, and attempted to dispose of, the assertions made by F & C; however, it did not and could not deny the statement just quoted (R. 36-38; R. 39-41).

It is obvious that Prima has tried to delay the early resolution of the controversy which it raised only after its first payment to F & C was overdue. It has done so because of the economic coercion it hoped to wield by delaying payments otherwise due to F & C. In *Necchi Sewing Machine Sales Corp.* v. *Necchi, S. p. A.*, 369 F.2d 579, 582 (2nd Cir. 1966), Judge Kaufman noted in his dissenting opinion that:

> "Speed is one of the great advantages of commercial arbitration. By resorting to a professional arbitrator to settle their disputes, the parties to a contract are able to avoid the delays, often measured in terms of years, due to crowded court dockets. But, if one or both of the parties to an arbitration agreement is permitted to engage in the 'protracted bickering and the delays,' or the

'extravagant and involved moves and counter-moves in state and federal courts,' such as the majority recognizes have occurred in the present case, commercial arbitration loses one of its main virtues. I find distasteful any practice which makes the Court a puppet to the tactics and manipulations of the parties."

The foregoing quotation is singularly apposite to the delays caused by Prima's naked and intemperate allegations of fraud, and this Court should reject such tactics out of hand.

## CONCLUSION

**For the foregoing reasons, the order of the United States Court of Appeals for the Second Circuit should be affirmed.**

Dated: New York, N. Y.
February 28, 1967

Respectfully submitted,

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